Response of Dominion Virginia Power to
Commission Staff's "Stranded Costs – An Accounting Perspective" Method
and the Virginia Committee for Fair Utility Rates' Method

<u>Commission Staff's "Stranded Costs – An Accounting Perspective" Method</u>

On April 29, 2003, the Commission Staff presented its methodology titled "Stranded Costs – An Accounting Perspective." According to the Staff, "[r]ecovery of stranded costs occurs throughout the capped rate period to the extent actual earnings exceed costs plus a fair return."

The Commission Staff's "Accounting Perspective" method is an attempt to reinstitute "ratemaking" during the capped rate period. Specifically, the Staff proposes to cap a utility's earnings at a Commission-approved rate of return and to treat any earnings above such return as a "recovery of stranded costs." The determination of this rate of return would require a stipulation or hearing on the proper ratemaking treatment of a utility's revenue, expenses, and investment. While the Staff proposes using each investor-owned utility's Annual Informational Filing ("AIF") as the basis for determining a utility's earnings, the inevitable disagreements would have to be resolved in a Commission proceeding.

The Commission's Rules Governing Utility Increase Applications and Annual Informational Filings ("Rules"), 20 VAC 5-200-30, are comprehensive. They specify what accounting schedules must be filed and what adjustments are permitted. For example, the Rules provide that an AIF filing cannot incorporate adjustments that were not approved by the Commission in a company's last rate case. Given that Dominion Virginia Power's 1996 case was a settlement in which accounting disputes were not decided, the Company's last relevant rate case was in 1992. *See Virginia Electric and Power Company, 1995 Annual Informational* Filing, Case No. PUE-1996-00036, and *Commonwealth of Virginia, At the relation of the State Corporation Commission, Ex Parte: Investigation of Electric Utility Industry Restructuring*;

Virginia Electric and Power Company, 1998 S.C.C. Ann. Rept. 322 (Aug. 7, 1998). *See also Application of Virginia Electric and Power Company, For an expedited increase in rates*, Case No. PUE-1991-00047, 1992 S.C.C. Ann. Rept. 291 (Dec. 29, 1992). Surely, the issues decided in 1992 differ from what is likely to be raised and decided in 2003. Dozens of new accounting, capital structure, and rate of return issues could be raised by the Staff and parties. In fact, the Commission formally approved a rule in 2000 that expressly recognizes the right of the Staff or of any party to raise new issues in AIFs. *See Commonwealth of Virginia, At the relation of the State Corporation Commission, Ex Parte: In the matter of Adopting Additions and Amendments to the Commission's Rules Governing the Filing of Utility Rate Increase Applications*, Case No. PUA-1999-00054, 2000 S.C.C. Ann. Rept. 140 (July 28, 2000).

The Virginia Electric Utility Restructuring Act (the "Act"), Va. Code §§ 56-576, *et seq.*, provides utilities with the flexibility to recover stranded costs over a reasonable period of time tailored to each utility. The Commission recommended this approach to the SJR 91 Subcommittee when the Restructuring Act was being considered. The Commission emphasized the importance of flexibility by stating "[i]f the General Assembly decides that at least some portion of stranded costs should be recoverable, we suggest a legislative approach to the determination and recovery of such costs that is specifically aimed at maintaining reasonable and necessary flexibility with respect to policy implementation and administration. We believe that this flexibility is critical to serving the public interest of Virginia in that such a process entails substantial complexity and uncertainty, poses potentially significant public impacts, and must address the unique circumstances of each utility . . . (emphasis added)." Comments from introduction to "SCC Draft Stranded Costs/Benefits Legislation," July 1998.

As enacted, the Restructuring Act provides for this flexibility. Specifically, the Act's capped rate provisions offer a clear incentive to electric utilities to reduce costs by July 1, 2007, in order to bring generation costs in line with the competitive generation market. To the extent utilities decrease their costs and increase their earnings, they have the opportunity and incentive to mitigate stranded costs in the exercise of their business judgment. These opportunities and incentives have been successful. For example, Dominion Virginia Power has spent or otherwise mitigated over $1 billion in generation-related costs since enactment of the Act. By any measure, it is making significant progress toward being an effective generation competitor by July 1, 2007.

Despite this, the Commission Staff now proposes to destroy the opportunities and incentives provided by the Act and replace them with a heavy burden. Instead of working to reduce costs, the Company would be forced to defend a rate case each year.[1] Instead of having the flexibility to negotiate with non-utility generators ("NUGs"), the Commission will assume that the Company has collected and spent each dollar it earns over a Commission-approved rate of return on stranded costs mitigation. In short, the Staff wants to "manage" the Company's mitigation efforts by requiring it to spend every available dollar on such efforts regardless of other priorities.

The Staff's proposal advocating rate of return regulation contradicts the Act. Virginia Code § 56-581 provides that " . . . subject to the provision of this chapter after the date of customer choice, *the Commission no longer shall regulate rates and services for the generation component of retail electric energy sold to retail customers.*" (Emphasis added.) The Virginia

[1] In fact, the Staff's approach raises the possibility that such proceedings might continue well beyond the capped rate period: "Continued earnings monitoring after the termination of capped rates on the unbundled generation business could provide a calculation of actual stranded costs or benefits on an annual basis." No purpose or justification under the Act for this extended monitoring is offered or apparent.

Code could not be more clear. In fact, the General Assembly set the Company's rates and, as discussed on page 7, provided for the Commission to revisit those rates only under the limited circumstances set forth in § 56-582.

Indeed, the notion that a utility's revenue requirement might be determined on an annual basis during the transition period, except at the request of the utility, was never proposed during the years of debate leading up to the Act. In fact, the Act compels just the opposite conclusion, as several provisions make clear. For example, except for the Company, every utility has the option of seeking a "going-in" rate case to have its capped rate levels fixed by the Commission. No other party, not even the Commission on its own motion, is permitted under the Act to initiate such a rate case, even if the existing rates are believed to be too high. Despite this, the Staff's "Accounting Perspective" incorporates a series of rate cases as its key feature. This method may involve fewer accounting adjustments than a proposed increase, but the Staff and parties would inevitably disagree over the major issue inherent in every rate case – a fair rate of return.

The Commission Staff is advocating a limit on the Company's flexibility just as the Company has begun to make progress in mitigating its potential stranded costs. For example, as a result of the Act, the Company has written off approximately $340 million in generation-related regulatory assets (in addition to the $220 million write-off approved in the 1998 rate case settlement).[2] The Company also has paid or otherwise mitigated approximately $370 million related to NUG contracts to reduce its above-market generation costs and has reduced operating costs another $100 million through efficiency measures. The Company has spent hundreds of millions of dollars on new transmission, distribution, and generation prospects

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[2] These amounts are Virginia jurisdictional.

and approximately $200 million for nuclear reactor vessel head replacements. Additionally, on April 18, the Company, the U.S. Environmental Protection Agency and five states announced a comprehensive agreement resolving disputes arising under the Federal Clean Air Act. Under the agreement, the Company will invest $1.2 billion in environmental projects, including advanced emissions control systems at the Chesterfield, Chesapeake, Yorktown, Bremo Bluff and Possum Point power stations in Virginia and the Mount Storm and North Branch power stations in West Virginia. Although the Company will make the expenditures through 2013, a considerable portion of them will be incurred during the capped rate period. This includes approximately $628 million in advanced technology to reduce nitrogen oxide emissions by 66 percent from 2000 levels. All this activity was made possible by the considerable flexibility afforded by the Act – flexibility that would be lost under rate of return regulation and stranded costs recovery "managed" by the Commission Staff.

Virginia Committee for Fair Utility Rates' Method

On April 29, 2003, Ed Petrini, counsel to the Virginia Committee for Fair Utility Rates ("VCFUR"), also presented a proposal to the work group. He described the VCFUR proposal as a combination of the so-called "Spinner method" and Commission Staff's "Accounting Perspective." The Company discussed the problems associated with Mr. Spinner's proposal in its comments filed on April 16, 2003, and its comments on the Staff's "Accounting Perspective" are set forth above. As made clear in those analyses, both proposals suffer severe shortcomings and do not comply with the Restructuring Act or with the directive of the Commission on Electric Restructuring (formerly the Legislative Transition Task Force) to develop an appropriate methodology for monitoring the over- or under-recovery of stranded costs. Mr. Petrini's effort to combine the two does not improve them. Indeed, his suggested approach incorporates an opportunistic modification that demonstrates what Mr. Spinner has admitted, i.e., his methodology would be "fraught with controversy every step of the way."

First, as Mr. Petrini says, the Act provides two sources of revenues for the recovery of just and reasonable net stranded costs--capped rates and wires charges. However, he then states that:

> . . . the amount that has been, or will be, available for recovery of such costs is the net revenue collected from wires charges and capped rates. Because the incumbent utility must collect sufficient revenue to recover its costs of providing service, the net revenue available for the recovery of just and reasonable net stranded costs is the revenue from capped rates and wires charges in excess of the revenue needed by the utility to recover its costs of providing service (*i.e.,* the utility's revenues in excess of its "revenue requirement").

Here, Mr. Petrini's method, like the Commission Staff's "Accounting Perspective," seeks to impose traditional rate of return regulation.[3] How much does a utility "need" to "recover its costs of providing service"? What is its "revenue requirement"? These are questions and concepts that frustrate the Act's deregulation of generation.

Mr. Petrini ignores the Act's most critical feature: the utilities' discretion to use available funds from the capped rates and wires charges, without the burden of Commission rate cases. Simply put, the Act created a "budget" for utilities for the entire capped rate period. How well they manage their budgets will be known on July 1, 2007. Utilities bear the risks of whether they will become competitive generators (the final results are unknowable until the end of the capped

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[3] Later portions of his proposal reinforce the impression of nostalgia for the old ways of regulation. Mr. Petrini candidly acknowledges that his approach "incorporates traditional ratemaking concepts in a regulated environment, including consideration of a utility's regulated cost of service used in setting 'just and reasonable' rates, and including concepts of 'prudence,' mitigation, verification...."

rate period), but they also have the flexibility to make and implement the best business decisions they can under this structure, without "second-guessing" by the Commission and others.[4]

As we have noted above in the Company's response to the Commission Staff, the Act imposed numerous strictures on the utilities, the Commission, and customers, consistent with those principles. First, capped rates can be examined and changed only for limited reasons: recovery of fuel costs, tax changes, financial distress of a utility beyond its control,[5] or a one-time change in non-generation rates under the special circumstances of § 56-582.C. Wires charges are reset only once a year, despite the vagaries the market may exhibit in the meantime.

Most significantly, many utilities were permitted to file an initial rate case under the Act for the purpose of establishing their capped rates, and the Commission was directed to decide such cases by giving "due consideration, on a forward-looking basis, to the justness and reasonableness of rates to be effective for a period of time ending as late as July 1, 2007." Thus, the rates fixed at the beginning of the capped rate period were to be considered just and reasonable for the entirety of that period. By necessary implication, the existing rates for the Company, which was denied the option of a similar rate case, were <u>legislatively</u> determined to be just and reasonable for the same time frame. Yet, Mr. Petrini now proposes to inquire into how much utilities "need," to examine periodically their "revenue requirement" during the capped rate period.[6] These pseudo rate cases are not sanctioned under the Act.

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[4] Of course, the Company has already offered in its proposal methodology to report annually to the LTTF (1) any over- or under-recovery associated with wires charge revenues; (2) the Company's potential stranded costs exposure; (3) the amounts spent on mitigation of stranded costs; and (4) additional expenditures that increase such costs.

[5] This provision alone clearly means that no other entity may seek to reduce capped rates.

[6] Mr. Petrini states that the Annual Informational Filings made by incumbents "would provide an acceptable basis for calculating a utility's historical cost of providing service and any revenues in excess of those costs that may be available for recovering stranded costs." With all respect to Mr. Petrini, AIFs are simply not recognized in the Restructuring Act, and may not be used as a mechanism to examine, or establish, a utility's "revenue requirement" during the capped rate period.

Second, Mr. Petrini describes the central concept of his approach as follows:

> To calculate just and reasonable net stranded costs compare asset values based on the <u>net present value of the difference between the revenues that arise from remaining in a regulated market</u> (cost plus a fair return) <u>and the revenues that arise in a competitive market</u> (over the life of the assets). From this amount subtract revenues via capped rates (to the extent capped rates exceed actual and likely costs including a fair return) and wires charges to determine the over- or under-recovery of just and reasonable net stranded costs.

(Emphasis added.)

By contrast, Mr. Spinner's method was described by Staff as follows:

> To calculate just and reasonable net stranded costs compare asset values based on <u>net present value cash flows that arise from remaining in a regulated market</u> (cost plus a fair return) <u>to the net present value cash flows that arise in a competitive market</u> (over the life of the assets). From this amount subtract recoveries via capped rates (to the extent capped rates exceed actual costs including a fair return) and wires charges to determine the over- or under-recovery of just and reasonable net stranded costs.

(Emphasis added.)

The underscored portions of each passage highlight the critical change Mr. Petrini has made to Mr. Spinner's method. In brief, Mr. Petrini would calculate the net present value of the <u>difference</u> between two cash flows, while Mr. Spinner would subtract the net present value of the competitive cash flow from the net present value of the regulated cash flow. In making this seemingly subtle modification, Mr. Petrini demonstrates how Mr. Spinner's methodology may be manipulated to produce a given result.

That is, it is not correct to assume, as Mr. Petrini does, that the appropriate discount rate to be applied to cash flows from a regulated enterprise is equal to the discount rate applied to cash flows from a competitive environment. The risks are quite different, and the competitive flows must therefore be accorded a higher discount rate to recognize that fact. Mr. Petrini surely is aware of this principle, and his attempted disregard of it shows that every aspect of the Spinner methodology would be ripe for endless maneuvering to "massage" the numbers to reach specific goals of the various parties.

Finally, Mr. Petrini acknowledges that his method would require "estimates based on long-term revenue and cost projections. Such estimates are data-intensive and highly sensitive to the underlying assumptions and models used in making them." As the Commission and its Staff have noted when addressing similar past proposals, problems such as these constitute additional significant reasons for not adopting such an approach. *See* Appendix A to Response of Virginia Electric and Power Company to Commission's Order Establishing Proceeding. The General Assembly had an opportunity to incorporate concepts such as Mr. Petrini's into the Restructuring Act in 1998 and 1999; it clearly did not and for good reason. They are inconsistent with the legislative background. Indeed, the Company knows of no consideration by the General Assembly or participants in the General Assembly's process of such a "twisted" methodology.

Response of Dominion Virginia Power to
Action Contemplated by Paragraph 9 of the LTTF Stranded Cost Resolution

<u>Proposal 1</u>

The methodology proposed by Dominion Virginia Power in Proposal 1 is consistent with the Virginia Electric Utility Restructuring Act (Act) and may be implemented by appropriate resolution adopted by the Commission on Electric Utility Restructuring (CEUR). The resolution to implement Proposal 1 may, pursuant to Section 56.595(C)(iii), provide for appropriate administrative action by the State Corporation Commission and all incumbent electric utilities requiring that the monitoring information called for in Proposal 1 be provided annually to the CEUR.

With Regard to the (1) Spinner Methodology as Supplemented by the Staff Accounting Perspective Earnings Test, as well as (2) the Petrini Methodology

The Spinner Methodology, either on its own or as supplemented by the Staff Accounting Perspective Earnings Test, (and as revised by the Petrini Methodology) is not consistent with the Act. These methodologies would provide for a utility-by-utility stranded cost quantification determination as well as a process which is equivalent to an annual rate case for each utility. During the 1998-1999 consideration of the Stranded Costs issue by the SJR 91 Subcommittee, as well as during 1999 when the General Assembly enacted the Act, methodologies like these were specifically considered and rejected. As a result of the inconsistency with the Act, the implementation of these proposals would require substantial amendment to the Act. It will be necessary for the legislature to amend the Act to establish a process to implement the these methodologies, since nothing in the present Act provides for authority to proceed under them. In fact, in many instances, the provisions of the Act are in conflict with the activities that would be necessary under these methodologies. Since the State Corporation Commission has no inherent powers to carry out these methodologies and is provided no authority to do so under the Act, legislation would be required. Unless the CEUR determines that it has the staff and procedures to carry out these methodologies itself, it is logical to assume that there will be a proposal for the State Corporation Commission, through appropriate proceedings, to carry them out.

It is useful to examine what issues would have to be resolved through legislation for the State Corporation Commission to have authority and direction to carry out these methodologies. The list would include:

- A determination as to the date upon which Stranded Costs are to be determined - 1998, 1999, 2000, 2001, 2002?
- Will Stranded Costs be quantified once or periodically between now and 2007?
- Do these methodologies apply to all incumbent electric utilities?

- In making the Stranded Costs determination under these methodologies, what is the appropriate time period for projections: the remaining useful life of generation facilities, 10 years, 20 years, 30 years?

- What impact on this determination do "stranded benefits" have either before July 1, 2007 or after July 1, 2007?

- How will discount rates be determined?

- In determining "market rates" what methodology will be used and what impact on that methodology will there be by use of the "market rate" determination features under default service?

- What will be the impact of the default service obligation of an incumbent electric utility on "market rates"?

- What will be the impact of capital obligations and operating expenses undertaken or incurred by an incumbent electric utility since the passage of the Act?

- How will a "fair return" be determined and what effect will the deregulated environment created by the Act have on that determination?

- In making the "cost of service" determination, will this be done either with or without regard to the passage of the Act?

- Will there be any limitations on the accounting adjustments or issues that can be raised in the process of determining cost of service or a fair return?

- When conducting the earnings test contemplated, what is period of time for which the earnings test will begin – 1998, 1999, 2000, 2001, 2002?

- Is the assessment of earnings to be made annually or over some other period? Is the earnings test for bundled rates (including distribution and transmission rates) or only unbundled generation rates?

- Does the earnings assessment terminate in 2007 or continue thereafter?

CONCLUSION

If the legislature chose to amend the Act to provide the necessary authority and direction to implement the Commission Staff's and VCFUR's methodologies, it follows that there are other issues that logically should also be considered by the legislature for amendments. They include:

- Should legislation authorize a process for an increase or decrease in capped rates depending upon information determined pursuant to this process?

- Should legislation authorize a process for the capped rate period to be extended or shortened dependent upon the results of this process?

- Should legislation authorize a process for an increase or decrease in the wires charge or for extending or shortening the period for a wires charge?

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